Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Poochigian	Analyst:	Marion Mann DeJong	Bill Number:	SB 818
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/25/1999
		Attorney:	Doug Bramhall	Sponsor:	

SUBJECT: Manufacturer's Investment Credit/Extend To Agricultural Commodities

SUMMARY

This bill would include activities related to the packaging, cold storage or preparing of agricultural commodities under the definitions of "qualified taxpayer" and "qualified property" in the Manufacturers' Investment Credit (MIC). This bill also would extend the carryover period for any unused credit resulting from agricultural commodities activities.

This bill also would make changes to the sales tax exemption for the same class of taxpayers, which does not impact the department's programs and operations.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately and would apply to taxable or income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

SB 671 (Stats. 1993, Ch. 881); SB 676 (Stats. 1994, Ch. 748); SB 38 (Stats. 1996, Ch 954.); SB 1106 (Stats. 1997, Ch. 604); AB 2798 (Stats. 1998, Ch. 323); AB 138 (1997/1998); AB 473 (1999/2000); AB 765 (1999/2000); SB 1075 (1999/2000).

SPECIFIC FINDINGS

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or investment property. The property must have a limited, useful life of more than one year and includes equipment, machinery, vehicles and buildings but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business.

Existing state law allows taxpayers to use various credits against tax such as the MIC. The **MIC** allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

Board Position:			Department Director	Date
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For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes in the SIC Manual. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used primarily:

- for manufacturing, processing, refining, fabricating or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control which meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that are an integral part of manufacturing, refining, processing or fabricating, or research and storage facilities that are part of the process, which are used by qualified persons performing manufacturing activities described in specific codes relating to computer, accounting, and office machines, electronic equipment and accessories, biotech or biopharmaceutical activities, semiconductor equipment manufacturing activities and certain aerospace manufacturing activities.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes (1) computers and computer peripheral equipment used in those businesses primarily for the development and manufacture of prepackaged software or custom software prepared to the special order of the purchaser who uses the program to produce and sell or license copies of the program as prepackaged software, and (2) the value of any capitalized labor costs directly allocable to the construction or modification of such property.

The MIC explicitly excludes certain types of property from the definition of qualified property, including equipment used in the extraction process, furniture, facilities used for warehousing purposes after completion of the manufacturing process, inventory, equipment used to store finished products that have completed the manufacturing process, and tangible personal property used in administration, general management, or marketing.

The MIC provides a variety of special rules for costs paid pursuant to a binding contract and leased property. The credit may be carried over until exhausted, for a maximum of eight years. For small businesses, this carryover period is extended to ten years. The taxpayer must recapture any credit previously allowed if the property is removed from California, disposed of to an unrelated party or converted to an unauthorized use within one year from the date the property is first placed in service in California.

The MIC will become inoperative on January 1, 2001, or on the January 1 of the earliest year after 2001 if the total employment in manufacturing in this state does not exceed by 100,000 jobs the total employment in manufacturing in this state on January 1, 1994.

The Employment Development Department (EDD) is required to report to the Legislature annually on this determination.

Certain “new businesses” (as defined) may claim an exemption from sales and use tax instead of this tax credit. The existing sales and use tax law also allows a taxpayer to claim a refund for the sales or use tax that was paid on the purchase of qualified property rather than claiming the MIC.

This bill would add SIC codes 0111 to 0291, inclusive, and SIC code 0724 to the definitions of “qualified taxpayer” and “qualified property” in the MIC. In the “qualified property” definition, the SIC codes would be added as well as an activity test describing any property used in the packaging, cold storage, or preparing of agricultural commodities. This bill also modifies the language excluding certain types of property from qualifying for the credit.

This bill would define “agricultural commodities” as the products of California farms and ranches and items processed from these products, forest products, aquacultural products, and fish and fish products produced in California and livestock fed in feedlots located in California.

This bill would define “preparing” as those activities which, after an agricultural commodity has been grown and harvested, are required in order to make the agricultural commodity ready for manufacturing, processing, or wholesale or retail sale.

This bill would define “tangible personal property that is primarily used in connection with the cold storage of agricultural commodities” as the specific capital equipment used for refrigeration, including, but not limited to, compressors, pumps, fans, heat exchangers, and related machinery specifically related to the refrigeration process. The term would include the refrigeration equipment in or outside the cold storage building that is purchased as a functioning unit to cool the building, but it would not include the cold storage building itself or any modification, such as insulation, wall coverings, or plumbing, made to the cold storage building.

This bill would allow an extended carryover period of unused credits for taxpayers in SIC codes 0111 to 0291, inclusive and SIC code 0724. For these taxpayers, the carryover period would be 11 years, rather than 8 years. For these taxpayers that also qualify as small businesses, the carryover period would be 16 years, rather than 10 years.

This bill specifies that the changes would apply to taxable and income years beginning on or after January 1, 1999, and before January 1, 2005, regardless of whether the existing increase in employment standard makes the MIC inoperative prior to that date.

For a more comprehensive list of the establishments included in these SIC codes, please see Attachment A.

Legal Consideration

This bill would provide a credit for property used in connection with the packaging, cold storage or preparing of specified agricultural products of California farms and ranches.

Thus, the bill would allow a credit for equipment used in connection with commodities produced in California, but would not provide a credit if the same activity occurs with regard to agricultural commodities produced outside of California. The effect of that distinction is to discriminate in favor of a local economy, which is likely an unconstitutional distinction under the U.S Commerce Clause. If the author intends to limit the credit for activities in California, this issue could be resolved by limiting the credit to property used in California. Department staff is available to assist the author with any necessary amendments.

Policy Considerations

This bill would allow the qualified taxpayers involved in agricultural commodities activities to claim the credit based on costs incurred in storing the commodities. This would establish a precedent for the MIC as no other taxpayers are allowed the MIC with respect to storage costs.

Implementation Considerations

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

- The definition of "tangible personal property that is primarily used in connection with the cold storage of agricultural commodities" conflicts with the general definition of IRC Section 1245(a)(3)(A) property used in the definition of qualified property for taxpayers engaged in agricultural commodities. It appears that “tangible personal property that is primarily used in connection with the cold storage of agricultural commodities” is an activity test and not a definition of property. Clear definitions and activity tests would avoid disputes between taxpayers and the department.

- This bill would extend the carryover period for unused credits for taxpayers engaged in specified agricultural activities. This may cause confusion for all other qualified taxpayers and may result in disputes between those taxpayers and the department.

Technical Considerations

Amendment 1 would change “taxable” to “income.”

Amendment 2 would capitalize the beginning of a sentence.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department’s costs.

Tax Revenue Estimate

Revenue losses from this proposal are estimated to be as shown below:

Estimated PIT and B&CT Revenue Losses
($ Millions)
Effective 1/1/99 Assumed Enacted after 7/1/99

1999-00	2000-01	2001-02
$(4)	$(6)	$(7)

This estimate does not account for potential changes in employment, personal income, or gross state product that might result from this measure. This estimate does not include changes in sales and use tax revenue that could result from this bill.

Tax Revenue Discussion

Qualified capital expenditures are estimated from depreciation reported by a 1993 California farm survey conducted by the United States Department of Agriculture, Economic Research Service. The qualified capital expenditure for 1993 was grow to 1999 expenditures by using California Department of Finance's forecasts of investment growth in machinery and equipment for 1999. This number was factored down using a ratio of qualified activity to overall agricultural activities to identify the qualified property under this bill. This yields an estimated 1999 base amount of $180 million. Applying the 6% tax credit to the base amount yields $10.7 million of which $4 million to be used to reduce tax credits in the first year.

SB 818 is identical to AB 138 of 1997, but the first year difference is due to incorporating recent findings on the timing of manufacturing investment credits claimed by taxpayers as well as changes in growth factor. Once the number for 1999 is derived, the numbers for 2000, 2001, and 2002 were similarly derived. The estimated PIT and B&C revenue losses were then calculated and extended to 1999-00, 2000-01, and 2001-02.

BOARD POSITION

Pending.

Attachment A
Standard Industrial Classification Codes 0111 to 0762

MAJOR GROUP 01. AGRICULTURAL PRODUCTION--CROPS
011 CASH GRAINS
0111 Wheat
0112 Rice
0115 Corn
0116 Soybean
0119 Cash Grains, Not Elsewhere Classified
013 FIELD GRAINS, EXCEPT CASH GRAINS
0131 Cotton
0132 Tobacco
0133 Sugarcane and Sugar Beets
0134 Irish Potatoes
0139 Field Crops, Except Cash Grains, Not Elsewhere Classified
016 VEGETABLES AND MELONS
0161 Vegetables and Melons
017 FRUITS AND TREE NUTS
0171 Berry Crops
0171 Grapes
0173 Tree Nuts
0174 Citrus Fruits
0175 Deciduous Tree Fruits
0179 Fruits and Tree Nuts, Not Elsewhere Classified
018 HORTICULTURAL SERVICES
0181 Ornamental Floriculture and Nursery Products
0182 Food Crops Grown Under Cover
019 GENERAL FARMS, PRIMARILY CROP
0191 General Farms, Primarily Crop

MAJOR GROUP 02. AGRICULTURAL PRODUCTIONS--LIVESTOCK AND ANIMAL SPECIALTIES
021 LIVESTOCK, EXCEPT DAIRY AND POULTRY
0211 Beef Cattle Feedlots
0212 Beef Cattle, Except Feedlots
0213 Hogs
0214 Sheep and Goats
0219 General Livestock, Except Dairy and Poultry
024 DAIRY FARMS
0241 Dairy Farms
025 POULTRY AND EGGS
0251 Broiler, Fryer, and Roaster Chickens
0252 Chicken Eggs
0253 Turkey and Turkey Eggs
0254 Poultry Hatcheries
0259 Poultry and Eggs, Not Elsewhere Classified
027 ANIMAL SPECIALTIES
0271 Fur-Bearing Animals and Rabbits
0272 Horses and Other Equines
0273 Animal Aquaculture
0279 Animal Specialties, Not Elsewhere Classified
029 GENERAL FARMS, PRIMARILY LIVESTOCK AND ANIMAL SPECIALTIES
0291 General Farms, Primarily Livestock and Animal Specialties

MAJOR GROUP 07. AGRICULTURAL SERVICES
072 CROP SERVICES
0724 Cotton Ginning

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FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO SB 818
As Introduced February 25, 1999

AMENDMENT 1

On page 27, line 28, strikeout “taxable” and insert:

income

AMENDMENT 2

On page 39, line 4 and line 8, capitalize “except.”